Year-end turbulence

Plummeting equity prices and elevated volatility reflect many anxieties. We share some concerns but remain confident for 2019.

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In a nutshell

- The year-end political and market turmoil complicates the forecasts for 2019.
- We share many of the concerns but expect a positive 2019, thanks to a still robust economy and better valuations.

Year-end turbulence

Plummeting equity prices and elevated volatility reflect many anxieties. We share some concerns but remain confident for 2019.

The job of equity strategists does not get any easier when equity markets correct – pull back at least 10% from their last high – or even enter a bear market with a 20% drop in the fourth quarter, just when the final touches are being put to the forecasts for the coming year. Nor does the situation improve when markets subsequently become either euphoric or panicky over trifles. The final straw is when major decisions are also expected around the turn of the year. Italy, Brexit and the (merely postponed) U.S.-Chinese trade dispute can trigger bouts of market weakness that initially militate against an optimistic outlook. Such turmoil can also make our forecasts look like it may be an opportune time to consider investing. This, however, is not necessarily the case. While our forecasts indicate where we see the indices trading at the end of 2019, they say nothing about the correct timing of investments over those 12 months.

Investors should not overestimate their ability to time the market anyway. But they should not underestimate either that major market moves create a powerful narrative of their own. Above all, the last two months have demonstrated yet again just how quickly price movements on the world's major exchanges can change the collective view of the economy and capital markets. Since market corrections can often be purely technical in nature, the key is not to jettison convictions from one week to the next. The resolve required has been demonstrated lately by the S&P 500's multi-day gyrations since the beginning of October: three times the index moved sharply lower (-11.4%, -6.5% and -11.1%) and twice higher (8.1% and 6.5%, as of December 20). A striking comparison is that all throughout 2017, as a whole the maximum potential loss (based on closing prices) never exceeded 3% – even based on the worst possible timing. But we think these days of excessive calm are over. Volatility at these higher levels will probably persist in 2019.

In the final analysis, there are still good reasons to expect more market turmoil before the situation improves. In 2019, we expect global GDP growth to slow only slightly, from 3.7% to 3.6%. Moreover, based on the current data, we see little reason to fear a cyclically driven recession in the United States in 2020. Our baseline scenario calls for global equities to generate single-digit returns next year, driven by moderate earnings growth and respectable dividends – the latter backed by strong corporate cash flows for

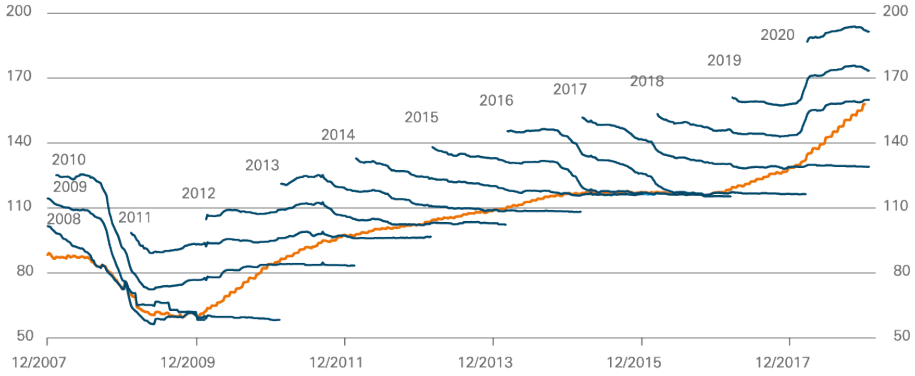
most sectors. We have set our December 2019 target for the S&P 500 at 2,850, for the Dax at 11,800, and for the Stoxx Europe 600 at 360 points.

Our basically bullish scenario could, however, be negatively impacted by a number of policy decisions. The recent market corrections and elevated volatility levels show just how concerned investors are about monetary policy in this late phase of the cycle – having previously, for several years, shrugged off any policy shifts. Our baseline scenario for the equity markets assumes they withstand a raft of policy decisions. We also assume the U.S. trade dispute will not escalate into a full-blown trade war. We expect the Fed not to tighten on auto pilot but to factor in deteriorating macro conditions, and also not to ignore the impact its actions have on equity markets and emerging markets (EM) in particular. We also assume that the Italian budget policy will not challenge the integrity of the Eurozone and that Chinese efforts to boost domestic consumption will prove successful, and permit a controlled slowing of the Chinese economy.

We no longer consider equity valuations to be rich. Valuations based on earnings or free-cash-flow multiples are at or below recent historical averages. The key question for equity investors is the sustainability of the current high level of profitability. We assume it to will remain high at least through 2019, but consensus estimates for most markets still have to be corrected downwards. In our view, they do not adequately reflect lower GDP growth, higher wages and new trade barriers. Overall, operating margins in developed markets will probably not rise further, so we think 5% to 6% earnings growth is an appropriately cautious assumption. We expect higher growth for emerging-market equities. Given the major uncertainty about near-term policy decisions, we are refraining from taking strong tactical positions – be it at a regional or sector level. Since the structural rise in the emerging markets looks set to continue in coming years, we are waiting for the right opportunity to overweight the region again. But for that to happen, the U.S.-Chinese trade dispute, the U.S. dollar and global interest rates must be heading in the right direction. We also assume that the digital revolution affecting virtually every sector will continue. Differentiating between the winners and losers of this technological shift remains a central investment issue for growth strategies. For the time being, however, even the heavyweights and former sector favorites must come to terms with falling instead of steadily rising consensus estimates. Here too we are waiting for better buy-in levels.

First blemishes in the very bullish forecasts

Consensus still expects another two fat years for S&P 500 earnings. The estimates* have, however, fallen slightly since late summer.



Trailing earnings estimates for S&P 500

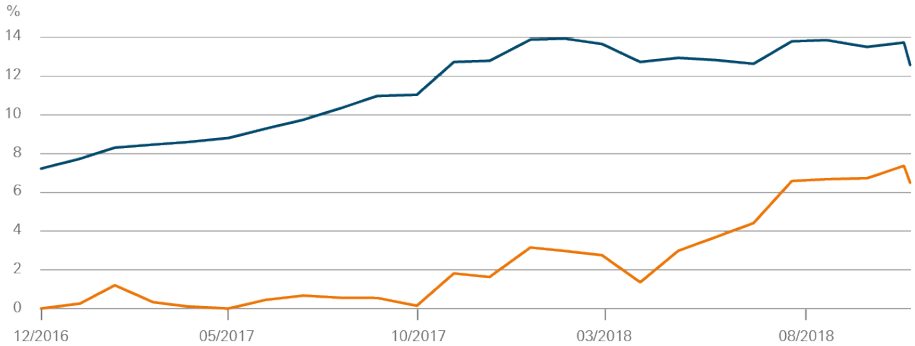
Source: Thomson Reuters Datastream as of 12/5/18
*Development of the earnings estimates for individual future years over time as well as continuous development of the earnings estimates for the last 12 months.

Valuations

Valuations overview

U.S. equities: Neutral (Neutral)*

Growth and valuation concerns have hurt U.S. equities. We feel sentiment has deteriorated too much. As we expect no recession, mid-single-digit earnings-per-share (EPS) growth in 2019 and 10-year Treasury yields no higher than 3.5%, we believe the correction offers some opportunities. There could be downward pressure though as earnings forecasts are starting to fall and Treasury yields offer an attractive risk-adjusted alternative.



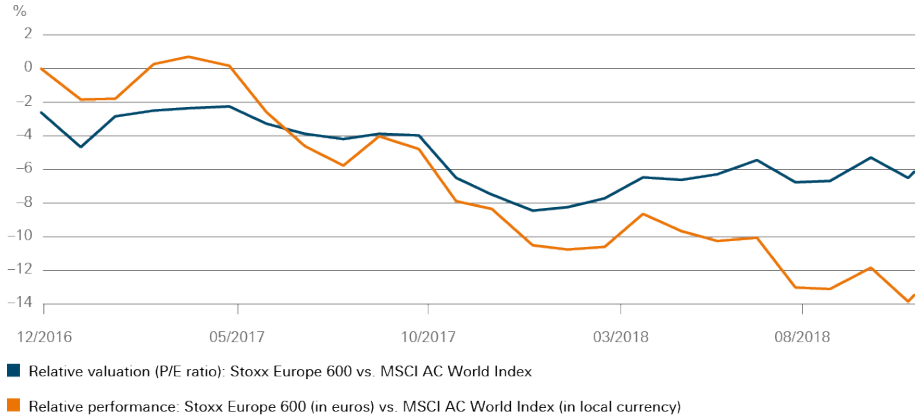
Relative valuation (P/E ratio): S&P 500 vs. MSCI AC World Index

Relative performance: S&P 500 (in dollars) vs. MSCI AC World Index (in local currency)

Sources: FactSet Research Systems Inc., DWS Investment GmbH; as of 12/5/18

European equities: Neutral (Neutral)*

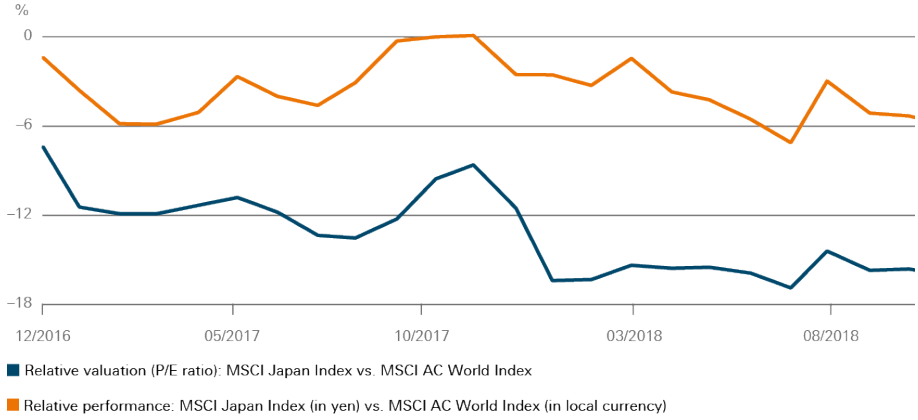
Political and macro uncertainties make it necessary to monitor how events in Europe evolve. Issues such as Italy, Brexit and trade tensions are weighing on markets. Therefore, we remain neutral and wait for a better re-entry point. In general, corporate fundamentals remain solid, and the recent drop in markets has made valuations look increasingly attractive, with the discount to U.S. price-to-earnings (P/E) ratios at 10-year highs.



Sources: FactSet Research Systems Inc., DWS Investment GmbH; as of 12/5/18

Japanese equities: Neutral (Neutral)*

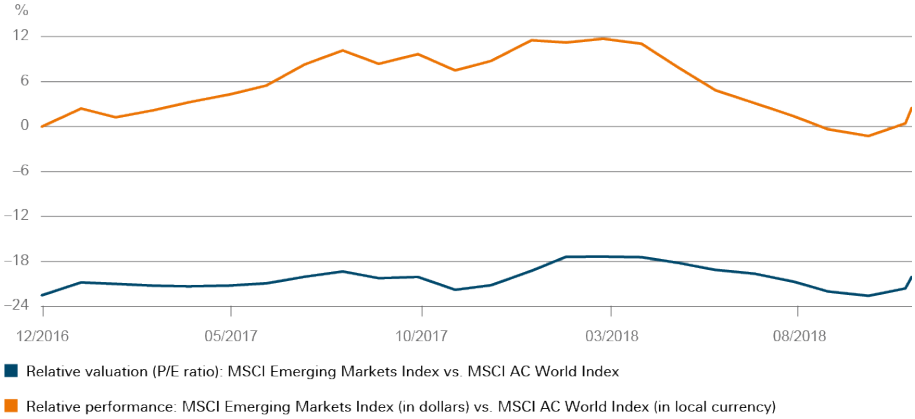
We believe strong balance sheets and solid earnings of corporate Japan remain fundamentally attractive. However, the signs of a slowdown in the earnings-recovery cycle leave us on the sidelines. Corporations have surprised by not yet revising up their conservative earnings forecasts. Furthermore, Japan may not necessarily be a place to hide if one expects a late-cycle slowdown.



Sources: FactSet Research Systems Inc., DWS Investment GmbH; as of 12/5/18

Emerging-market equities: Neutral (Neutral)*

Emerging markets (EM) will be an interesting asset class in 2019. While there are risks that a stronger U.S. dollar (USD), higher U.S. rates or a trade-war escalation will weigh on EM equities, this is not our base case. On average, EM companies have strong balance sheets and they are trading at compelling valuations. We believe, however, that earnings forecasts still need to come down, depending also very much on Chinese growth.



Sources: FactSet Research Systems Inc., DWS Investment GmbH; as of 12/5/18

*Our assessment is relative to the MSCI AC World Index , the last quarter's view is shown in parentheses.

Glossary

Balance sheet

A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

Bear market

Technically, a **bear market** refers to a situation where the index's value falls at least 20% from a recent high.

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

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Bull market

A **bull market** is a financial market where prices are rising - usually used in the context of equities markets.

Consensus estimate

A **consensus estimate** is a figure that depicts the average of different analysts' estimates about the performance of a particular asset.

Correction

A **correction** is a decline in stock market prices.

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Dax

The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Developed Markets (DM)

A **developed market (DM)** is a country fully developed in terms of its economy and capital markets.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM)

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Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Free Cash Flow (FCF)

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

Fundamentals

Fundamentals are data giving information about the general well-being of companies, securities or currencies and serving for the subsequent valuation of these as an investment opportunity.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth strategy

A **growth strategy** is an investment style that is focused on an investor's capital appreciation through capital gains. Investors following this strategy seek to invest in companies whose earnings are expected to grow at an above-average rate compared to the industry or the overall market.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

MSCI AC World Index

The **MSCI AC World Index** captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

Multiple

A **multiple** is a ratio that is used to measure aspects of a company's well-being by setting various of the company's metrics against each other and thereby building indicative ratios.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Stoxx Europe 600

The **Stoxx Europe 600** is an index representing the performance of 600 listed companies across 18 European countries.

Technical analysis

Technical analysis is a tool used by capital market participants that want to forecast the development of security prices by detecting patterns in past market data such as prices and volumes.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investments in Foreign Countries – Such investments may be in countries that prove to be politically or economically unstable. Furthermore, in the case of investments in foreign securities or other assets, any fluctuations in currency exchange rates will affect the value of the investments and any restrictions imposed to prevent capital flight may make it difficult or impossible to exchange or repatriate foreign currency.

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Hedge Funds – An investment in hedge funds is speculative and involves a high degree of risk, and is suitable only for "Qualified Purchasers" as defined by the US Investment Company Act of 1940 and "Accredited Investors" as defined in Regulation D of the 1933 Securities Act. No assurance can be given that a hedge fund's investment objective will be achieved, or that investors will receive a return of all or part of their investment.

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Investment in private equity funds is speculative and involves significant risks including illiquidity, heightened potential for loss and lack of transparency. The environment for private equity investments is increasingly volatile and competitive, and an investor should only invest in the fund if the investor can withstand a total loss. In light of the fact that there are restrictions on withdrawals, transfers and redemptions, and the Funds are not registered under the securities laws of any jurisdictions, an investment in the funds will be illiquid. Investors should be prepared to bear the financial risks of their investments for an indefinite period of time.

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